FINDINGS AND CONCLUSIONS

WITH RESPECT TO

A PUBLIC HEARING CALLED IN RESPONSE TO

SENATE RESOLUTION NUMBER 114

SUBMITTED TO

THE CALIFORNIA STATE SENATE

BY

THE CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE

C. BRUNEL CHRISTENSEN, DIRECTOR

NOVEMBER 30, 1974

STATE OF CALIFORNIA RONALD REAGAN, Governor

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N Street
Sacramento
95814

November 30, 1974

Honorable James R. Mills
President pro Tempore
State Senate
State Capitol, Room 5100
Sacramento, CA 95814

Dear Senator Mills

In response to Senate Resolution No. 114, the California Department of Food and Agriculture called a public hearing which was held on September 17, 18, and 27, 1974.

The Department transmits herewith a report containing the Findings and Conclusions based on our evaluation of the public hearing record.

The Department is also transmitting a copy of the hearing transcript for your reference.

Sincerely

C B Christensen

C. B. Christensen
Director

Senate Resolution No. 114

Introduced by Senators Moscone, Ayala, Beilenson, Cusanovich, Dymally, Gregorio, Holmdahl, Kennick, Marks, Mills, Nejedly, Petris, Rains, Robbins, Roberti, Rodda, Wedworth, and Whetmore

August 9, 1974

REFERRED TO COMMITTEE ON RULES

Senate Resolution No. 114—Relative to fluid milk pricing.

WHEREAS, Fluid milk and fluid cream are necessary articles for human consumption; and

WHEREAS, In order to insure an adequate, continuous, but not excessive supply of fresh and wholesome fluid milk at reasonable prices to consumers, the Legislature has prescribed the terms and conditions for the establishment of minimum producer, wholesale, and retail prices for fluid milk by the Director of Food and Agriculture; and

WHEREAS, Dramatic changes have occurred in the fluid milk industry in recent years; and

WHEREAS, Concern has been expressed by many segments of the fluid milk industry, many school districts, and the public at large that the practices of the Department of Food and Agriculture in administering the fluid milk stabilization and marketing provisions has not kept pace with such changes and have resulted in the establishment of minimum producer, wholesale, and retail prices which are not in conformity with the intent of the Legislature; and

WHEREAS, Current minimum prices for fluid milk are at record high levels; and

6 114 20 15

WHEREAS, the public has begun to respond with a boycott of fluid milk, and thousands of gallons of fresh, nutritious milk have been destroyed recently; and

WHEREAS, Three petitions by consumers and Members of the Legislature for hearings on the use of alternative pricing methods which are available under existing law have been denied by the Director of Food and Agriculture; now, therefore, be it

Resolved by the Senate of the State of California, That the members hereby request the Director of Food and Agriculture to hold public hearing or hearings, as soon as feasible, to consider evidence on whether milk prices can be reduced and the destruction of fresh milk halted by administrative action under existing law; and be it further

Resolved, That the Director of Food and Agriculture report his findings and recommendations, based on such public hearing or hearings, to the Senate not later than December 2, 1974; and be it further

Resolved, That the Secretary of the Senate transmit a copy of this resolution to the Director of Food and Agriculture.

STATE OF CALIFORNIA RONALD REAGAN, Governor

CALIFORNIA DEPARTMENT OF AGRICULTURE

1220 N Street
Sacramento
95814

August 28, 1974

NOTICE OF PUBLIC HEARING

Notice is hereby given that the Director of the Department of Food and Agriculture, State of California, acting pursuant to the provisions of Chapter 2, Part 3, Division 21 of the Food and Agricultural Code, has called a public hearing to be held in the Assembly Room (Room 127), 1220 N Street, Sacramento, beginning at 9:30 a.m. on September 17, 1974, for all Milk Marketing Areas in California.

This hearing is being called by the Director to give consideration to the subjects contained in Senate Resolution No. 114 relative to fluid milk pricing. The Senate Resolution No. 114, adopted August 16, 1974, by the Senate, reads as follows:

"WHEREAS, Fluid milk and fluid cream are necessary articles for human consumption; and

"WHEREAS, In order to insure an adequate, continuous, but not excessive supply of fresh and wholesome fluid milk at reasonable prices to consumers, the Legislature has prescribed the terms and conditions for the establishment of minimum producer, wholesale, and retail prices for fluid milk by the Director of Food and Agriculture; and

"WHEREAS, Dramatic changes have occurred in the fluid milk industry in recent years; and

"WHEREAS, Concern has been expressed by many segments of the fluid milk industry, many school districts, and the public at large that the practices of the Department of Food and Agriculture in administering the fluid milk stabilization and marketing provisions has not kept pace with such changes and have resulted in the establishment of minimum producer, wholesale, and retail prices which are not in conformity with the intent of the Legislature; and

"WHEREAS, Current minimum prices for fluid milk are at record high levels; and

"WHEREAS, the public has begun to respond with a boycott of fluid milk, and thousands of gallons of fresh, nutritious milk have been destroyed recently; and

"WHEREAS, Three petitions by consumers and Members of the Legislature for hearings on the use of alternative pricing methods which are available under existing law have been denied by the Director of Food and Agriculture; now, therefore, be it

"RESOLVED BY THE SENATE OF THE STATE OF CALIFORNIA, That the members hereby request the Director of Food and Agriculture to hold public hearing or hearings, as soon as feasible, to consider evidence on whether milk prices can be reduced and the destruction of fresh milk halted by administrative action under existing law; and be it further

"RESOLVED, That the Director of Food and Agriculture report his findings and recommendations, based on such public hearing or hearings, to the Senate not later than December 2, 1974; and be it further

"RESOLVED, That the Secretary of the Senate transmit a copy of this resolution to the Director of Food and Agriculture."

Any changes which may be found to be necessary as a result of this hearing would be implemented through subsequent hearings either on an individual marketing area basis or on a consolidated basis, whichever is determined to be administratively expeditious.

You are cordially invited to attend and present credible testimony and evidence at the hearing.

C. B. Christensen
Director of Food and Agriculture

By L R Walker

L. R. Walker, Chief
Bureau of Milk Stabilization

FINDINGS AND CONCLUSIONS

WITH RESPECT TO

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NOVEMBER 30, 1974

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The following findings and conclusions are based on material issues raised at a public hearing held in Sacramento, California, on September 17, 18, and 27, 1974.

This hearing was called in response to Senate Resolution No. 114 relative to fluid milk pricing wherein the Resolution requested the Director of Food and Agriculture to hold public hearing or hearings to consider evidence on whether milk prices could be reduced and the destruction of fresh milk be halted by administrative action under the existing law. This Resolution also requested the Director of Food and Agriculture to report his findings and recommendations based on such public hearing or hearings to the Senate not later than December 2, 1974.

The following discussion will cover the findings resulting from the hearing. The Department's recommendations for restructuring the Milk Act will be contained in a separate report.

There were two material issues discussed at the hearing. They were (A) "Can the price of fluid milk be reduced?" and (B) "Does the Department have the administrative authority to prevent the destruction of milk?". A third category (C) will cover miscellaneous issues which were testified to at the hearing which are also covered in these findings.

A. The first question will be approached from three specific levels; namely, the price paid to dairy farmers by distributors, the wholesale price, and the retail price. The findings and conclusions are necessarily couched within the framework of the statute and the administrative authority of the Director of Food and Agriculture.

1. <u>Producer Price Level</u>

The testimony and evidence presented at the hearing alleging that producer prices could be lower was regrettably lacking in factual information. Only one witness, introduced as being an expert by a consumer representative, challenged the need for the present level of producer prices. The qualifications of that witness as being an expert were not all that apparent.

The witness assumed that the total rollback could be justified by the elimination of producer quotas which were created under the California Milk Pooling Program. The contention of this assumption was that the cost of quotas paid by some dairymen inflates the cost of production which is used in establishing the minimum producer price. This contention is erroneous. No costs for quota are included in the production cost audits made by the Department. Cost audits include only those costs of production directly attributed to the dairy enterprise and those marketing costs associated with transportation from the dairy farm to the plant of first receipt.

The witness's testimony was correct in establishing that the price differential between the overbase price and the quota price gives rise to the value of quota. However, the assumption made that the overbase or Class 4 price is or closely approximates the "free market" price is subject to question. The Class 4 price and "overbase" price are synonymous. This price level fluctuates with the free market demand for butter, skim milk powder, and hard cheese and is the lowest classified price which any dairy producer receives.

The "free market" price was described by the consumer witness to be that price which would recover costs plus a reasonable profit and which would also develop adequate supplies for consumers needs. The "overbase" price does not fit this criterion. Manufacturing grade milk has been priced at or slightly above the recovery value for butter and powder for over fifty years, yet manufacturing grade milk has virtually disappeared in California. The demise of this supply does not support the contention that the "overbase" price level could maintain a sufficient milk supply for the market and cover the production costs, including a reasonable profit.

The average price for overbase milk from January through September of 1974 was $6.11 per hundredweight, while the average production costs through June 1974 averaged $8.36 per hundredweight. This obvious price disparity would preclude a price rollback to the overbase level as suggested at the hearing.

The Production Cost Index, developed by the Bureau of Milk Stabilization, was criticized at the hearing. Again, unfortunately, no other cost information or critical analysis of the costing procedure was offered.

The California milk stabilization program is cost oriented in the establishment of minimum prices. This is unlike most other milk price control programs. In most other markets, price differentials above the Minnesota-Winconsin manufacturing milk prices are used in establishing the Class 1 price. The differential system is not cost oriented, but is designed to encourage sufficient production to supply the market at a level which is felt to be adequate for the market. This differential system is used in Federal Milk Market Order Areas. Over the years, producer prices and consumer prices have been substantially higher under the Federal Milk Market Order system than under the California milk stabilization program.

The cost of producing fluid milk cannot and does not stand alone as the only standard in establishing a minimum Class 1 price.

The current supply available to the market must be taken into consideration. The overall supply of milk cannot be perfectly tailored to the demand. Every dairy farm produces milk 365 days a year, including holidays. Cows produce milk when nature prompts them to do so. Consumers purchase milk according to individual shopping habits. Unfortunately, seasonal patterns of production and consumption do not coincide. They are actually very different on such times as weekends, holidays, vacation periods, and different seasons of the year.

Virtually all other food production and processing industries are able to maintain a regular flow of products and assure adequate consumer supplies through storage reserves. The only way the dairy industry can assure consumers of having all the milk and other dairy products they desire is through the supply of milk which is produced each day. There must be an over supply in the periods of high natural production and low consumer demand if ample supply is to be available in the periods of natural low production and high consumer demand.

This seasonal overproduction is necessary to insure that each consumer in each market will have all of the milk required by them at the time and place they require it. Each family expects milk to be available at all times. A milk man or grocery store out of milk would be unacceptable to consumers.

The lowering of milk prices in an effort to move all production into milk consumption is futile since lower prices do not stimulate consumption to the extent needed to utilize all milk in fluid form. Milk has a relatively inelastic demand.

Conclusion

It is, therefore, concluded that minimum prices paid to producers should not be reduced. The application of production costs, fluid milk supplies, and manufacturing milk prices as basic standards for establishing minimum prices do not support the allegation that raw product prices are excessive or in violation of the public interest.

2. Wholesale Price Level

This is a most difficult question to answer relative to a price reduction under the conditions currently existing at the wholesale level in the major Milk Marketing Areas of California. In fact, it is not the basic question to be answered. The fundamental problem at this time would appear to be whether it is possible to administer the current minimum wholesale pricing program under existing circumstances in these markets.

In order to explain the present situation, it is necessary to briefly review the Food and Agricultural Code standard for establishing wholesale prices and also the structural changes that have occurred in these markets in recent years.

The specific standard for establishing minimum wholesale prices is found in Section 62479(g) of the Code. To paraphrase briefly, this Section provides that, in establishing minimum wholesale prices, the Director shall take into consideration the reasonably necessary costs of handling fluid milk, including a reasonable return on investment, of sufficient efficient distribution for the area. Section 62487 adds further that the minimum wholesale prices shall be sufficient, but not more than reasonably sufficient to cover costs, as such costs are described in Section 62479(g).

For many years, these standards provided wholesale prices which resulted in reasonably stable markets. However, within approximately the past ten years, the spread of vertically integrated operations have caused serious problems to develop in the wholesale pricing program.

Integration of a large chain of supermarkets with a fluid milk processing plant makes for a highly efficient operation. In addition to spreading the costs of management and fixed overhead between two operations, integration can eliminate advertising, bad debts, sales expense, etc. They process only the "long run" items, such as half gallons of fluid milk, and purchase the "short run" and costly to handle by-products. They serve only large volume stores, thus eliminating the small costly serves. In a recent sample of cost studies done by the Department, the half gallon costs of a vertically integrated plant, including delivery, was six to seven cents below the average costs of the two most efficient conventional distributors. These large differences in cost provide a strong incentive for the operators of large independent markets to purchase their controlled products at competitive prices.

A further surge in integration has developed in the past few years with the advent of joint venture. Selected medium and large volume stores are now able to procure their controlled products at net prices below the established minimums through the use of dividends which are a part of this arrangement. Today, approximately 50 percent of the milk sold by retail stores in the two major Milk Marketing Areas is handled through some type of vertical integration. This means, in effect, that 50 percent of the volume of sales through stores is unregulated at the wholesale level.

This increase in sales through integrated outlets has come about largely at the expense of conventional distributors. These are the processors who serve a full line of dairy products to all types of wholesale accounts, including retail stores, restaurants, and the various institutions, such as schools and hospitals. The loss in volume to integration is reflected in the rapidly rising unit costs of these distributors.

The result of these changes in market structure is that there are now actually two separate and distinct types of wholesale distribution. On the one hand, there is the highly efficient low cost integrated type and, on the other hand, the relatively less efficient higher cost conventional type of wholesale distribution.

In actuality, these conventional distributors can process and distribute milk to the large supermarkets as efficiently as integrated plants. The problem is that their average costs are increased greatly by their function of serving the smaller high cost deliveries to small stores, and consumed-on-premise outlets.

Thus, in the past several years, the Department has been faced with the dilemma of establishing wholesale prices which will enable conventional distributors to cover their average costs, but at the same time allow them to remain competitive with the low costs of integrated distributors. This has been found to be a next to impossible task and has resulted in the suspension of minimum wholesale prices in five Milk Marketing Areas within the past year.

Some indication of whether or not wholesale prices could be reduced may be gained from what has occurred in these markets since minimum prices were suspended.

In the four Central California markets where controls on wholesale prices have been temporarily suspended, prices for small to medium size stores have remained approximately unchanged. Prices to the large volume captive prone stores have dropped. In the North Central Valley Milk Marketing Area, the half gallon price reduction was just under four cents; in the Southern San Joaquin Valley, about three and one-half cents. Average net prices, depending on the mix of a distributor's business, have dropped somewhat less than the three and one-half or four cent reduction.

Wholesale prices were only recently suspended in the San Francisco Bay Area. As of this date, new prices have been filed by only one major distributor. An analysis of these price filings indicates a different pattern from those in the Central Valley Areas.

For full service customers, this distributor has increased prices sharply. On the half-gallon container, these prices are increased from three and one-half to four cents, depending on the size of purchase.

For comparable service, prices to limited service high volume accounts are also increased from two to three cents per half gallon.

For what is termed "Economy Service", prices remain about the same up to the level of a $700 purchase. At the $700 level, there is a reduction of approximately nine mills per half gallon.

This price filing is obviously an attempt by this distributor to overcome some of the problems outlined above. Overall, his average net return must be increased to cover costs, but he must remain competitive for stores who have the option of becoming members of a joint venture. The approach here is to increase revenue from the smaller accounts and reduce costs by offering services comparable to those provided by integrated operators. A preliminary estimate would indicate that this distributor's cost-price relationship will improve slightly under these filed prices. Much of this improvement will depend on the extent to which costs can be reduced under the "Economy Service" program.

From a review of these suspended areas, it would appear that average wholesale prices for conventional distributors, given the present market structure and under the existing law, cannot be reduced. While average prices were lowered in the Central Valley markets under suspension, these prices appear to be below cost based on preliminary analysis of data available to the Department. Increased efficiency of the distributors presently serving these markets would seem to be the only solution to this problem. This could best be accomplished through free market forces.

A consumer representative testified at the hearing that conditions of monopoly have been encouraged by the pricing factors employed by the Department. The only evidence presented in support of this was a statement that in 1970 there were nearly twice as many vertically integrated operations in this State as in any other part of the country. Equating vertical integration with conditions of monopoly is not believed valid. Competition between vertically integrated entities can be as intense as that between competitors in a conventional system of marketing.

All available data leads to the opposite conclusion; namely, that concentration in California markets is among the lowest in the country. If suspension of wholesale prices continues, there is every indication the number of distributors will be reduced. This will certainly be a move toward monopoly.

Reference is made to Exhibit No. 18 in the report to the Senate on May 7, 1974, and to the report of the National Commission on Food Marketing, June 1966. Reference is also made to Exhibit No. 17 of the May 1974 report showing the percentage change in the number of commercial fluid milk bottling plants in the United States as compared to California.

Another consumer representative testified that wholesale prices could be reduced by three cents per half gallon. The evidence supporting this demand was the fact that when the Department suspended wholesale prices in the Southern San Joaquin Valley this spring, the half gallon wholesale price to large buyers dropped three cents.

Because of competitive conditions, this price reduction did occur. All indications are, however, that these prices are below cost at the present time. A restructuring of this market will occur at these price levels eliminating some of the present competitors. When this process has been completed, all cost evidence would indicate that prices would stabilize at levels above those currently prevailing, but possibly below the level of the suspended prices.

Conclusion

It is concluded that when the factual evidence before the Department is considered under the applicable statutory standards, a general reduction of wholesale price levels cannot be made. The polarization of costs between the two basic distribution practices indicates margins for one group may be larger than necessary, while the other group receives insufficient margin returns. The development of these two basic marketing methods, each serving special types of customers, has defied the establishment of equity and stability under the mandatory pricing standards.

3. Retail Price Level

Consumer witnesses testified that the minimum retail prices for milk could be reduced four cents a half gallon by decreasing the gross margins that are being allowed to large supermarkets. While some of the consumer testimony was without specific evidence, some did present comparisons of gross margins on milk to gross margins on other food items. Their comparison showed that milk had a higher gross margin than powdered milk, flour, oil, peanut butter, coffee, sugar, and butter. It is evident that most of these items do not require cold room storage, refrigerated shelving, and have minimal spoilage losses.

One consumer witness also compared the average gross margin of fluid milk in California of 19 to 22.6 percent to a national average of 17.2 percent. The national average figure could not be verified as the witness did not offer the source of the information in her testimony.

GROSS SPREAD IN THE UNITED STATES COMPARED TO CALIFORNIA MARKETS
SECOND QUARTER OF 1974
HALF GALLON FLUID MILK SOLD AT STORES

	U.S. 1/	LOS ANGELES	SAN FRANCISCO
Retail Price	80.1	71.0	72.0
Raw Product Cost	43.4	42.5	41.9
Gross Spread	36.7	28.5	30.1

1/ From the Marketing and Transportation Situation
Economic Research Service - U.S.D.A., August 1974

An industry witness testified to the incremental cost items that were identifiable with milk sales. The total of these cost increments was 21.1 percent. The witness also presented data on the gross margin percentages of nondairy items. Examples were: bread - 20 percent, beverages - 20 percent, delicatessen items - 30 percent, beer - 25 percent, and canned fruits and vegetables - 22 percent.

In establishing a minimum retail out-of-store price, Chapter 2, Article 23, Section 62479 of the Food and Agricultural Code, gives the Director two alternative standards: (1) the overall average cost of doing business, or (2) the cost of handling milk in the retail store.

It has been the Department's policy to establish an out-of-store price that allows stores, purchasing in the larger discount brackets, a percent gross margin equal to the overall cost of doing business.

In formulating the Central Coast Counties Marketing Area Order Number 44, which became effective October 19, 1974, the Department reduced the minimum retail out-of-store price for fluid milk from 72 cents per half gallon to 71 cents. Without any changes in the wholesale prices, this retail price yields a gross margin of 20.07 percent for those stores buying at the largest volume. The lowest overall cost of doing business in this Area was 19.94 percent.

This tighter resale pricing policy in other major Milk Marketing Areas of the State would probably result in a decrease of one or two cents per half gallon. Under the existing statutes, this is the only alternative that could reduce retail prices, until a survey of the in-store cost of handling milk is completed.

The Director established a general policy in March 1973 for future determination of retail store margins. Included in this was the basic principle of developing impartial cost surveys of retail store operations on the cost of handling fluid milk incurred by stores. A costing procedure has been in the development process over a period of many months and is currently being applied to a sample of stores to test the procedure. Within a few weeks, additional studies will be undertaken to develop a larger representative sample. When those studies are completed, the Director will be able to apply either alternative standard in establishing minimum retail prices. Preliminary in-store studies indicate store margins are questionable. This is one area that could provide some relief to consumer prices on milk. It must be recognized that reduced milk margins would, no doubt, result in higher margins for some other food items in order for the store to maintain its overall profit margin. However, this should not affect any determinations in the establishment of proper store margins

A reduction in retail prices by any method will undoubtedly result in most small grocery and liquor stores selling milk at a greater differential above the supermarkets than they are currently. If this upcharge becomes too great, it could affect their economic position in the market.

A similar problem arises with the retail home-delivery price. A reduction in the out-of-store price and no change in the home-delivery price would certainly reduce the number of home-delivery customers. Whereas, if the current differential between these two types of outlets are maintained, the operating margins of the retail home-delivery operator will be reduced.

Conclusion

Due to the alternative methods available to the Director in establishing retail store margins, the level of store margins could vary significantly, depending on which method was used. The extent of any margin differentials that may result between these methods will be more identifiable when in-store handling cost audits are completed. At that time, it will still be necessary for the Director to determine which alternative standard should be used with supporting justification for that decision.

B. The second material issue in Senate Resolution No. 114 asked if the Department of Food and Agriculture had the administrative authority to prevent the destruction of milk. First, the circumstances surrounding this disposition of skim milk and then, the issue raised in the resolution will be discussed.

1. Destruction of Skim Milk

Many witnesses at the hearing expressed deep concern over the destruction of skim milk which occurred in Southern California. The decision to dump the skim milk was made by a Southern California dairy farmer cooperative whose members produced the milk. This cooperative was newly formed through a merger of three smaller producer marketing cooperatives. Two of these cooperatives did not have any plant facilities. The third had a small bottling plant, a separator, and limited storage silos. It did not have any facilities to manufacture dairy products. This small plant does not have sufficient capacity to handle the amount of milk produced by either its original membership or the combined group. Most of the milk is delivered to larger bottling facilities.

The fact that the name of this new cooperative is California Milk Producers Association led many to allege that all California dairymen participated in this event to maintain the price level. In reality, the members of this cooperative suffered the total physical and economic loss. It appears self-evident that, in the present cost-price squeeze the dairy industry is experiencing, no dairy farmer is going to suffer a deliberate loss if a viable alternative is available.

Witnesses testified that the milk production cycle does not coincide with the consumption cycle. Production depends on the biological nature of the cow and varies seasonally, with the peak coming in June and July and the low falling in December and January. Consumption, on the other hand, peaks in the fall months and is at its lowest in July and August. Thus, in order to insure an adequate supply to meet the peak consumer needs in the fall, an excess must be produced during the June-July peak production period. This excess has been called "reserve" or "standby" supply. One witness stated that the industry supplies milk to the consumer when it is demanded, not as it is produced. Still, the industry must handle all milk produced.

Under normal circumstances, most of the standby supply is converted into butter and powder in processing plants located in the San Joaquin Valley. However, these powder plants were operating at full capacity during the peak production period this year. This was verified by the Department and restated at the hearing by a witness engaged in the processing business. Shortages of approved bags for powdered milk and tin containers for condensed milk hampered the usual flow through the processing plants, further complicating the plant backup. In addition, one powder plant was closed on October 1, 1973, because it was uneconomical to operate. This reduced in-state plant capacity.

A witness pointed out that out-of-state cheese processing facilities, which usually absorb a goodly portion of California's reserve production, were unable to receive the usual amounts because of additional large and untimely cheese imports allowed by the federal government. As imports moved into the trade replacing United States cheese, domestic buyers put the cheese plants on quantity allotments. As storage space was limited for the finished product, the plants could not operate at full capacity. When these out-of-state plants could take milk, it was difficult to obtain trucks to make the haul as it takes three times as many trucks to move the same amount of milk to Oregon, Utah, or Idaho on a continuing basis as it does within California.

With no powdering facilities of its own and unable to secure a home for its production, the cooperative separated the milk, sold the cream, and finally disposed of the skim milk. They knew more milk would be coming in from ranches and dumped the skim to make room for the fresh milk. This cycle continued with the oldest skim being dumped. One witness, commenting on this point, succinctly stated, "Assuming the Director could halt the destruction of fresh skim milk, we would ask, what is the Director going to do with the milk he has saved? Surely, if facilities for processing milk had been available, the milk would not have been threatened with destruction in the first place."

When the action was publicized in the newspapers, the complete dairy industry was shocked. Through industry-wide cooperation, enough trucks were made available to move some reserve milk into cheese plants in Utah and Idaho when capacity was available. This, along with numerous spot shipments to local cheese plants, alleviated the abnormal stress on the cooperative. The destruction of skim milk ceased on July 17, 1974. To illustrate how rapidly things change, it might be interesting to note that one witness stated the same cooperative which discarded the skim milk last summer was now buying milk from other producers to supply its major customers.

In the Auditor General's preliminary report to the Legislature on the Milk Marketing Program dated September 16, 1974, it was reported that 420,000 gallons of skim milk was dumped by the California Milk Producers Association. The Los Angeles County Sanitation District was identified as the source of this information. The Department's investigation in progress indicates this figure to be reasonably accurate.

To the average person, this is a monumental amount of skim milk. However, to put it in proper perspective, it was approximately one-half of one percent of California's production during the time the skim milk was dumped. To put it another way, milk plants in California were able to handle approximately 99.5 percent of all milk produced during the peak production period. Only one-half of one percent was lost due to insufficient facilities. This by no means is an attempt to justify this action, only to quantify its magnitude.

The Department received numerous letters and telephone calls after the dumping had stopped asking why this milk was not given to needy, low income families. This is a very ligitimate question, especially in an inflationary time when the cost of living is rapidly escalating. Obviously, it could have been used for this purpose if some organization had a system ready to handle the skim milk properly.

In reality, the problems of sudden disposal are many. One has to ask what do you do with a tanker of raw skim milk? State Health Laws require raw milk to be pasteurized before it can be used for human consumption if it does not come from a certified herd. Since the normal market for these producers is through pasteurized outlets, these herds were not certified.

In addition to being pasteurized, the skim milk would also have to be packaged so it could be handled easily. While cartons with distributor labels were available, it is questionable that a distributor would accept the liability associated with others using his label for give away purposes. After the skim was processed and packaged, a distribution system would have to be organized to distribute it and keep it refrigerated so the temperature would not exceed 45 degrees. Another problem is selecting the particular area where the skim milk is to be given away. Since the total amount lost would not supply all the low income families in the State, someone would have to decide which ones would receive this windfall benefit.

Assuming all these steps were properly arranged for in advance, there still remains one hypercrucial question. Who is going to underwrite the cost of these various functions? Many people have suggested the California Legislature, the Department of Food and Agriculture, or the County of Los Angeles should have shouldered this responsibility. It is highly doubtful that any of these had budgeted funds to handle such an emergency. It is certain there are no funds in the Department's budget for this purpose. Other people suggested the cooperative who dumped the skim milk should stand this cost. It doesn't seem reasonable to expect those dairy farmers who lost the total value of their skim milk to underwrite the cost of giving it away and, thus, compound their loss.

It appears that it would be very costly and rather impractical for any organization, government or private, to maintain standby facilities to process extremely limited surpluses for charitable purposes, no matter how appealing such a venture may seem. An organization established and funded to provide this service would have to depend on free skim milk. While it is believed dairy farmers would prefer to give skim to a charitable organization rather than dump it, it is also believed that they would prefer to sell their skim rather than give it away. It would be difficult to keep an organization primed and ready to act when even the group with potential surpluses might not know exactly what day it would occur.

2. <u>Administrative Authority to Prevent Destruction of Milk</u>

Since the destruction of skim milk or any other food violates the moral code, The Legislature was prompted to ask if the destruction of fresh milk can be halted by administrative action under existing law.

Many people have cited Sections 58381, 58382, and 58383 of the Food and Agricultural Code as the legal authority requiring permission and the issuance of permits before the destruction of agricultural products can take place. This language was added to the Code to prevent unscrupulous brokers from defrauding farmers who had consigned fresh fruits and vegetables to them for sale. These brokers could tell the farmer that his product had spoiled and had to be dumped so they would be relieved of financial responsibility and pocket the money. If the goods consigned truly became unfit for human consumption, these Sections provided for an authorized third party to verify the condition and issue a permit which is really a certification that the broker was absolved from further financial liability.

Some people read Section 58381 as an absolute prohibition for anyone to destroy agricultural products. However, this Section contains four qualifying words: "in restraint of trade". These words are not defined or clarified in the Chapter and it seems necessary to rely on Sections 58382 and 58383 for proper interpretation. These Sections state very explicitly that the permits for destruction are for agricultural products consigned for sale.

If Section 58381 truly means that no one can destroy food, then every farmer would have to obtain a permit each year or be in violation during harvest. We all know that machines and humans do not operate at 100 percent efficiency and some product is lost no matter how good the intentions. A carrot, lettuce, or other fresh vegetable farmer would be required to obtain a permit to disc his fields if the price plunged to such low levels that it was uneconomical for him to harvest. Perhaps the farm labor unions would also be required to obtain a permit before they engaged in strikes, secondary boycotts, or other activities which usually result in the loss of agricultural products.

Permits have never been required for these types of food losses when the product is in the hands of the producer. Neither has a permit been required for others who destroy food as long as they own it. Restaurants, stores, and even the housewife trim and discard to make the end product more attractive.

Present regulations appear to be adequate to control the wanton destruction of food products once a particular product has entered commercial channels. However, the Department does not believe that it has the authority to prevent the destruction of products that are still in the hands of the producer or grower.

It may be argued that the Director has sufficient indirect authority provided under Chapter 2 of the Milk Act to prevent the destruction of raw milk. This lies solely in the minimum pricing authority and accompanying marketing provisions which require the development and maintenance of adequate reserve supplies.

It should be noted that the law prohibits the Department from limiting production.

There is necessarily a delicate balance between a condition of shortage and one of excess. This balance is dependent on a proper reserve supply. The amount of reserve milk needed to assure that all distributors be fully supplied at all times and in any season varies from one Milk Marketing Area to another. However, there is no major market in California or, for that matter, in the country that does not need and have substantial quantities of reserve milk. There is, of course, limitations to the amount of reserve milk needed for each market. People not understanding the everyday operating problems of milk producers and processors often find fault with the levels of reserve supplies which are necessary in serving the market. California markets do not have available to them a reserve supply from sources outside of the State and must, therefore, bear the burden of occasional oversupply in the market.

To some market observers with limited or no experience in the marketing of milk, there seems to be a tendency toward quick solution in solving the reserve supply. The quickest answer often proposed is to lower the price in order to clear the market of current supplies. That has not proved possible in any known instances in the country. Later increases in price because of shortages prove totally unacceptable to consumers.

The requirement of maintaining an adequate supply of milk runs into an occasional risk of excess milk during the flush season. Even so, a review by the Legislature of necessary supply levels inherent in the producer pricing standards is appropriate.

Conclusion

It is the Department's conclusion that:

1. There is no authority in the existing law that would have permitted the Department by administrative action to halt the destruction of raw skim milk.

2. A law that would prohibit dumping or wasting of agricultural products would be almost impossible for farmers to live with because of modern mechanical harvesting processes, production cost-price relationships and labor disputes.

3. Nonetheless, every effort should be made to recover all edible food products.

C. Much of the testimony presented by various witnesses relative to the following three points was erroneous and apparently based on misinformation or lack of understanding of the statute and the milk pricing orders.

1. Rates of Milk Price Increases Compared with Other Food Products

A number of references were made by different witnesses on the rate of milk price increases. One stated the price to consumers had risen 33 percent in the past year. Another stated milk prices had increased 33 percent since the spring of 1973. Actually, the price of milk in the Southern Metropolitan Marketing Area (Los Angeles and vicinity) increased 20 percent from September 1, 1973, to September 1, 1974, and 31 percent from January 1, 1973, to September 1, 1974. These changes were higher than in other major Marketing Areas.

Witnesses also stated the price of milk has increased at a greater rate than other foods. That is true if the time period is limited to the past year only. However, when comparing the rate of change over a longer period, milk price increases have not risen as fast as the consumer price index for all food. From January 1, 1971, to September 1, 1974, the price of all foods in the Los Angeles-Long Beach Area increased 45.9 percent, while one-half gallon of milk rose 36.6 percent.

Inflationary changes do not register their effects on all commodities at the same time or at the same rate. A longer time frame must be used to make any reasonable comparison. All comparisons, using more than the past 12-month period, show milk price increases were more temperate than all food items. If one used the period from April 1, 1974, to date, the data would show no increase in milk prices and sizable gains in all other food items.

Conclusion

It can only be concluded that the criticism and complaints directed toward milk prices are unfounded by facts and that fluid milk has not increased as much as other food items.

2. Purpose of Milk Law

Many statements and inferences were made that the milk law was intended to protect the small operator, whether it be the dairy farmer, processor, distributor, or retail store. Nowhere does the statute make any reference to indicate the legislative intent was to protect any particular size of operator, nor do any provisions tend to convey that impression.

If the statute were so interpreted, it would tend to be in direct conflict with other specific provisions which state the statute should promote and maintain satisfactory marketing conditions, and bring about a reasonable amount of stability and prosperity in the production and marketing of fluid milk.

One of the basic standards which the Director must recognize is contained in Section 62479(e). This states, in part, "The reasonably necessary cost of handling fluid milk...which is incurred by distributors...as such costs are determined by impartial cost surveys...of all, or such portion of the distributors in such marketing area as are reasonably determined by the director to be sufficiently representative to indicate the reasonably necessary costs of sufficient efficient distribution for such marketing area."

The following characteristics were recognized as basic reasons for the enactment of the milk law:

(a) The peculiar nature of the supply and demand for milk for fluid purposes. Fluid milk is bulky and highly perishable. Its production is a continuous process, which fluctuates widely by season of the year. Consumption, on the other hand, remains relatively constant. This means that, if consumer demand is to be supplied at all times, surplus milk will be available at periods of peak production.

(b) The market structure of the fluid milk industry is another feature which contributes to the need for some form of price control. The industry has a relatively small number of distributors, some of whom are very large. Producers, on the other hand, are many in number with considerable variation in size. As a result, there exists a great disparity in market power in the absence of price regulation. This is especially true in periods of surplus production.

(c) The local nature of the supply areas and the continuous relationships between producers and distributors is another special feature of the fluid milk industry. This characteristic makes the administration of price controls both possible and feasible.

The application of resale price regulation on top of producer price control was believed necessary to preserve stability at the wholesale and retail levels of sale. The danger of severe price wars developing at the retail level is particularly acute. Fluid milk is one of the items used as a "traffic builder" by retail grocery store operators. Thus, it is particularly susceptible to price cutting by supermarkets. This can lead to destructive competition which will permanently alter the market structure. When a sufficient number of competitors are eliminated from the market, semimonopolistic conditions develop with prices administered by the few large surviving firms. While the intermediate stages of this process may temporarily benefit consumers, in the long run, consumers will not benefit when competition is severely restricted.

Conclusion

It was for the above reasons California's milk stabilization laws were established--not to protect the small dairyman, distributor, or retail store operator.

3. Profit Versus Margin

Some witnesses testified to the effect that profits of 20 percent or more were being realized by retail stores. Profits were considered synonymous with the term "gross margin". The average gross margin of retail stores tends to revolve around the 20 percent figure. However, net profits for the store tend to be only about one percent of sales. It is important that margin and profit are properly interpreted and defined.

Margin is the difference between the cost and the selling price of a product.

The word "profit", when used by itself in this context, is practically meaningless and should be defined as either gross or net profit. The term "gross profit" is generally used to refer to the total sales of a business less the cost of goods sold. Net profit is gross profit minus expenses. When referring to a single item, margin or gross profit are synonymous.

4. Inflationary Trends

Much of the testimony developed an undertone of innuendos that the price of milk was the major inflationary problem and that lower milk prices would tend to solve the food budget problems.

The dairy industry, for many years, has absorbed price increases through increased efficiencies. This held the consumer price change to a minimum while other food prices rose more rapidly. When feed prices began spiraling in late 1972 and 1973, any efficiencies in the milk marketing system were overshadowed and the effects were abruptly forced upon the consumer. Since milk is a complete and basically unchanged raw food product, sudden changes in production costs will be more noticeable in the consumer price than in most other food products for which there are alternatives or substitutes.

The following data depicts the dramatic change in dairy farm production costs due to feed price increases during the past two years.

TOTAL FEED COSTS AND TOTAL ALL COSTS PER HUNDREDWEIGHT
FOR TWO MAJOR PRODUCTION AREAS
1969 - 1974

	1969	1970	1971	1972	1973	1974
	$	$	$	$	$	$
Southern San Joaquin Valley						
Total Feed Costs per Cwt.	2.63	2.64	2.83	2.93	3.79	5.12
Total All Costs per Cwt.	5.10	4.85	5.18	5.33	6.43	8.25
Southern Metropolitan						
Total Feed Costs per Cwt.	2.75	2.90	3.15	3.09	4.12	5.42
Total All Costs per Cwt.	5.62	5.72	5.94	5.88	7.27	9.00

5. The Milk Price Law Versus Welfare

Many consumers testified that milk price increases had taken milk out of their reach. One legislative representative testified that the government (inferring the Director) has an obligation to see that the full burden of any milk price increase does not fall upon the consumer. The representative said, in part, "...the government...has an obligation to see to it that the prices do not rise to an exorbitant level." It must be again emphasized that the milk law is a pricing law and there is no authority to consider it as a welfare subsistance law.

In the Los Angeles Superior Court, Case No. C83989, Palacio and Dias vs. C. B. Christensen, May 3, 1974, in reference to testimony objecting to price increases, the Court stated the following:

> "...This is a complex business, and I think you've got to have a little more sophisticated approach to it as far as the evidence undoubtedly available and as far as the experts that can be called in to testify. These hearings are not like court hearings...it is just not done in this type of hearing, but nobody likes inflation. Everybody is unhappy with inflation. I can appreciate that. We all suffer the results of that, but it does not seem to me that the type of evidence presented here by the consumer group was the sophisticated type of evidence that you need when you are going to alter the price structure that has been established for many decades... this is a complex sort of matter, and if you want to change the relationship, and that is what you are doing in effect... then I submit there is an obligation to submit more persuasive evidence other than that the people are basically unhappy with increase in costs, because that is not the answer..."

It becomes quite apparent that ever-increasing percentages of our income will be required for food. It is also apparent that there are increasing numbers of low income people who depend on social security, welfare, food stamp programs, unemployment, and other socialized type programs.

Conclusion

Prices for milk or any other food items cannot be subsidized by the grower, manufacturer, or retailer to fit the purchasing power of these below-average income groups. If people in these circumstances do not have sufficient funds to provide adequate nutritious diets, this becomes a social problem that must be handled by society in general and not by any particular industry.

6. Control Versus the Law

Much of the consumer testimony favored suspension or abolishment of government price regulation programs. Again, minus factual evidence, the inference was that, no matter what the minimum price may be, it is too high, and it is too high because the government sets it. Pages of factual data were introduced showing that milk prices in California are, with few exceptions, the lowest in the nation. However, this is ignored by pinpointing only the weaknesses of the program. Sans regulation, there are faults and weaknesses in prices established under so-called free market conditions.

It is increasingly apparent that the philosophy of price control changes like the wind. When there are no controls and prices increase, consumers tend to demand price restrictions on the things they buy. When controls are put on prices, they then contend the prices are too high because of regulation.

There tends to be a general philosophy that governmental regulatory programs are bad, no matter what the results show.

Conclusion

It is conceded that the pricing program can no doubt be improved. However, with all the objectionable features alluded to by testimony, the established prices cannot be so wrong that the public interest is entirely violated when California consumers have the benefit of some of the lowest milk prices in the nation.

There are very apparent differences of opinion as to the Director's administrative authority as evidenced by testimony. Many criticisms of the program are valid. Some of these areas of criticism can only be eliminated through changes in the law.

7. Nutrition Pricing

A number of witnesses alluded to the need for recognition of the nutritional contribution of milk to human health and that prices of such nutritional products be held within the reach of all consumers.

Under questioning, one witness conceded the law did not provide for pricing based on the nutritive value. California, through the milk stabilization program, is the only state in the United States that has moved away from the traditional milk fat value as a basic standard. In 1962, the minimum Class 1 prices were modified to recognize the increasing value of components other than milk fat in its pricing scheme. Current prices do, therefore, give recognition to the components of milk having the greater nutritive values.

Conclusion

There is no authority for the Director to subsidize the fluid milk prices to provide abnormally low milk prices to consumers. It must also be recognized that under "free market" conditions, prices of consumer goods are determined under the basic supply and demand criteria without any particular recognition of nutritional values.

8. <u>Equalization of Quota Versus Class 1 Prices</u>

Testimony was entered that prices could be reduced to consumers if equalization of quota among all producers was accomplished. This assumes the thesis that equalization would permit a reduction in Class 1 prices paid to dairy farmers. In theory, this may develop a strong argument of support. However, there are many factors which are inextricably intermingled that can offset the assumed equity of equalization.

It is difficult, if not impossible, to discuss pooling methods without becoming involved in questions of "equity" and "market rights". Essentially, pooling involves the sharing or averaging of market returns. The type of pool determines the particular individuals whose returns are to be so averaged. Changing the pooling procedure necessarily involves an alteration of the allocation of total returns among participants and, thus, relative to the previous situation that existed between individuals, some are benefitted and some are penalized.

Equity may be defined in terms of conditions which treat all producers in a uniform manner. This definition is not without fault. It is equitable not to discriminate among individual dairymen only if it can be determined that all the individuals involved are alike in all relevant attributes. It likewise follows that, if differences do occur, treating them all in a uniform fashion involves discrimination and inequity.

<u>Conclusion</u>

It would appear that some discretion must be given to the Director to compromise a strict definition to one that is, in his determination, reasonable. However, there does appear to be a need for some legislative change to permit a more definite schedule for achieving equalization among producers.

9. Reserve Milk Supply

The level of supply, over and above the Class 1 needs, is one of the areas criticized by various consumer witnesses. There has been a historical trend to larger necessary reserves as population areas change and as competitive market conditions have evolved. Changes in consumers' buying habits, along with the centralization of production and distribution facilities, have created the need for additional reserve supplies. When milk was delivered to the home daily or on alternate days, the demand was more constant and reserves less a factor. Today, most of the milk is purchased at the supermarket on weekends and consumers demand fresh milk. This creates the need for adequate reserve facilities to handle the milk during the days when fluid processing facilities are closed down. There must also be sufficient production to assure adequate supplies of fresh milk for the "peaks" of demand.

Initially, the statute referred to a supply that would insure consumers a sufficient quantity of milk. The law was amended in 1957 to delete the reference to Class 1 needs and substituted a supply for all purposes. The market experienced about 15.5 percent reserve during 1956. During the years from 1957 to 1971, the supply in excess of Class 1 usage expanded to 36 percent. In 1971, the Legislature again amended the statute relative to supply standards and expanded the interpretation to read "current and prospective supplies of fluid milk in relation to current and prospective demands for such fluid milk for all purposes, including manufacturing purposes".

The above change could only be interpreted to mean the supply standard has been too conservative and should be increased. In 1973, legislation was passed effective January 1974 to move most heavy cream products from Class 1 to Class 2, and in a separate legislative bill, required all Class 2 products be made from market milk.

Conclusion

Under these supply standard changes, it has been difficult to find any agreement in an attempt to define or interpret these standards. Recommendations for corrective action will be made in a separate report.

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